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Geopolitical events are threatening to steal the spotlight, the Fed is signaling a change in its accommodative policies, inflation is the highest in decades and yet markets have been able to remain at or near all-time highs. Can anything derail risk assets right now? This month we discuss these issues and more with a distinguished panel of subject matter experts on the markets and economy. I think you will find their responses not only thoughtful but helpful to the investment decisions you are having to make right now.

Rich Blair *will be a new name for many of the PCM Report readers but is hardly new at navigating the markets. Rich is a SVP of Research at SKK and is charged with developing investment strategy and serves on SKK's Research Committee and Investment Committee. Rich cut his investment teeth serving in the investment office of Amhert College.*

Sam Stovall *is a luminary in the investment management world but maybe best known for his unique ability to bring humor to what is often otherwise dry economic data. I could list all of Sam's accolades and accomplishments, they are many, but will simply say that 5 minutes with the man and you become infected with his zeal and passion for what he does. We are grateful to call Sam friend and partner of PCM.*

Clint Pekrul *serves as the Director of Research and Portfolio Manager at PCM and is a prolific writer as well. Clint has written groundbreaking research on incorporating Factors in portfolio allocations. He is a recognized expert on ETF implementation and developing rules-based hedging strategies and oversees the Dynamic Risk Hedged portfolios at PCM when not fly fishing or rooting for OU football.*

It is impossible to ignore the tragedy unfolding before our eyes in Afghanistan. The pictures out of Kabul take many back to a very remorseful time in our country's history. Setting aside the politics, how might the Taliban gaining control of Afghanistan impact the markets and economy?

Sam, what does your vast reservoir of knowledge and data suggest?

SS: Military/terrorist shocks have historically impacted headlines more than bottom lines since the effects typically dissipated quickly as investors concluded that they would not result in a global recession. Indeed, in the 1 and 3 months after the fall of Saigon on April 30, 1975, while the S&P 500 gained 4.4% and 1.7%, respectively, the S&P 500 Aerospace & Defense sub-industry jumped 15.4% and 26.0%. Even though history should be viewed as a guide and not gospel, CFRA thinks the Aerospace & Defense group offers a favorable investment opportunity today as it sports an aggregate STARS ranking of 4.6 out of 5.0, with 7 of 11 component companies carrying favorable investment outlooks by CFRA equity analysts.

Brian, what concerns do you have from the unfolding events?

BL: Conflict on the other side of the world, in and of itself, would be unlikely to become an issue for the markets from a historical perspective. The actions mostly raise political questions, and this is not the forum to have that conversation. My biggest concern is where we are in the current cycle and with valuations. It is entirely possible that investors are in search of a reason to sell and reduce portfolio risk. Some investors will use the headlines as an excuse to reduce equity exposure and lead to a market correction. I would view Afghanistan as a political and social quagmire so any impact on the markets and economy should be transitory.

Clint, are there potentially larger geopolitical risks you see arising?

CP: The risk to the markets directly might not be that impactful unless a hostage situation arises. The markets overall have kept hitting new highs despite the fall of the war-torn region. The risk at this point is geopolitical as the general perception is that the U.S. cut and run after a twenty-year presence after 9/11. To fill that vacuum, China has indicated it is willing to work with the Taliban, which could have longer-term implications for U.S. foreign policy.

To you, Rich, is there the potential for a "tipping point" scenario?

RB: Afghanistan 2019 GDP per capita was $507 USD, representing less than 5% of the global GDP per capita ($11,417). The economy is largely dependent upon the public sector and international aid, while the private sector is largely focused on low-productivity agriculture. Illicit activity is rampant. While the impact of a Taliban led Afghanistan is unlikely to have a direct effect on US markets, the tangential impact may be significant. The US pullout from Afghanistan marks the end of a 20-year era of actively policing the Middle-East. If the US continues to evolve towards isolationist policies, then its absence in global politics may leave a void to be filled by other parties. China shares a border with Afghanistan and has already established itself as a willing donor and lender to Afghanistan's neighbors. Within the US itself, voters have very short memories. Despite this withdrawal being negotiated in February 2020, the scenes of a disorganized withdrawal reflects incredibly badly on the Democrats. How that impacts upcoming mid-term elections may have substantial trickle-down effects on the economy, including continued fiscal stimulus and the appointment/reappointment of Federal Reserve Chairman Powell.

It appears Republicans are well-positioned going into the mid-term elections given the split in the Senate and the narrow Democrat majority in the House. Even the Democratic Congressional campaign leader suggested Democrats would lose the House if voting occurred today. Do you expect Republicans to control one or both legislative branches and how might that impact the always forward-looking markets?

Brian, what does your crystal ball of politics tell you?

BL: If I was a betting man, I would say it is highly likely that Republicans control the House after the mid-term election and somewhat likely they control the Senate given the Senators who are up for reelection. The good news for investors should be that any far-left leaning policy initiatives that would reshape the American economy (Green New Deal, Universal Basic Income, etc.) would no longer be part of the narrative. Most importantly, the markets have clearly fared better when Congress is divided between parties rather than controlled by a single party. Bloomberg data from 1950-2019 shows that when Republicans control both sides of Congress average annual returns were 13.4%. When Democrats control Congress the average returns were 10.7%. When Congress is divided the average annual returns is 17.2%. Republicans controlling at least one chamber is very likely to be celebrated by investors.

Rich, how big a hurdle does the GOP face this mid-term cycle?

RB: Republicans need to win just 5 seats to regain the House and to convert a single seat to take the Senate. However, it is important to evaluate the specifics when considering the likely outcome of upcoming elections. There are 34 Senate seats up for grabs in the 2022 election cycle. Republicans represent 20 of those seats and have at least 5 Senators not seeking re-election due to retirement. On the Democrats side, 13 of the 14 Senators have announced intentions to seek re-election. Key battleground states that could flip from blue to red are Georgia, Arizona, New Hampshire, and Nevada, while the Republicans will be most concentrated on retaining Florida, Pennsylvania, and North Carolina. Remember, Arizona and Georgia both flipped from red to blue during the 2020 special election but did so by very thin margins; they could easily revert back.

In the House of Representatives there are 6 special elections in 2021: Louisiana (2x), Ohio (2x), New Mexico, and Texas. Louisiana, New Mexico, and Texas elections have been held and no seats were flipped. Ohio will have a runoff in November. Florida will also have a special election in 2022. I would expect to see political gridlock with room for moderate compromises in the event Republican are able to take the House or Senate. The markets love predictability, and nothing is more predictable than a stalemate in a split Congress.

Sam, surely there are factors other than who controls Congress that investors should be mindful of.

SS: History says, but does not guarantee, that the Republicans have a very good shot at taking control of both houses of Congress, following the mid-term elections in November 2022. Since 1950, the six first-term Democratic Presidents saw an average net loss of four seats in the Senate and 26 seats in the House. A similar decline in party representation would tip the scales to a 54-46 majority for the Republicans in the Senate and a 238-196 majority in the House. While this might seem calamitous to the Democrats, the S&P 500 has traditionally responded well in the 3rd year of a president's term in office, rising an average 19.8% in price and never declining (though 2011 was essentially flat).

Your thoughts, Clint, on the likelihood of the political landscape changing in 2022?

CP: A Republican takeover of at least one of the legislative branches would not be surprising, especially given the recent decline in President Biden's approval rating over the Taliban's rapid takeover in Afghanistan. There are several scenarios that could work against the Democrats. A deterioration in Afghanistan would put continued downward pressure on the President's approval rating. Likewise, if inflationary pressures within the U.S. economy accelerate, we could see a rise in interest rates which could slow things down at home. With a split in the Senate and a razor thin margin in the house, it wouldn't take much to tilt both chambers to the Republicans.

There has been a growing chorus of voices on both sides of the aisle questioning President Biden's competency. Article 4 of the 25th Amendment has never been exercised in U.S. history. Is this a risk that investors should factor in their investing decisions? How might President Biden not serving out his entire term be viewed by investors?

CP: As far as market risk is concerned, I think there are more legitimate scenarios that could unfold to shake investor sentiment. President Biden is 78 years old. If there is truly some physical ailment such as dementia that inhibits him from fulfilling his duties as president, Congress could make a case to remove him. But the political hurdles for removing a standing president would be enormous. Biden's replacement, Kamala Harris, is a polarizing figure politically. If she were to assume office, I would imagine the Republicans would gain control of at least one chamber of Congress in the mid-terms. The result would likely be gridlock. The markets might respond well to that.

Sam, any Black Swan type of event in the brewing?

SS: I think President Biden will be a one-term president. Indeed, I think most investors feel that way. However, invoking Article 4 of the 25th Amendment in order to remove him early, would be embarking on a slippery slope. Doing it once would open the door to attempting to do it (by both parties) more frequently as a form of political retribution. Should he step down voluntarily, elevating Kamala Harris to the Presidency, the market might experience a sharp but short setback after investors conclude that the administration's policy agenda would likely remain largely intact until the next election.

Rich, do you have any concerns about the potential fallout of pursuing Article 4?

RB: Joe Biden was elected under 12 months ago, and although the political climate is as contentious as ever, the removal of such a newly elected President via Article 4 of the 25th Amendment would be directly at odds with the decision of the American people. Removing the sitting President on grounds of incompetence would be a near-sighted decision for either political party that would undermine the stature of the Office and carry long-term implications for political stability.

Kamala Harris would assume the Presidency in the event Joe Biden was removed from office. While Kamala Harris has outwardly embraced the political and economic views of Biden, investors may view this transition as a shift towards a more progressive and less moderate agenda based on Harris' own 2020 election platform initiatives.

Brian, this is not exactly unchartered waters given the dual impeachments of recent history. Your thoughts?

BL: I do not believe we are likely to see an Article 4 of the 25th Amendment pursued. It seems more likely that if President Biden loses the support of his party to the degree an Article 4 could be pursued he would resign before going through that process. Watching the reporting occurring with Afghanistan, it does seem clear that the President is losing support from all sides and much of what he says is being parsed and used to make him look bad. I believe the "risk" Biden leaves office before his term ends has risen dramatically. On the surface, you would expect the uncertainty surrounding a presidential transition to cause a risk-off approach to equities but given that we have already been through impeachment without much of a market disruption it could be a non-event, particularly if Congress is divided.

You cannot escape the debate about inflation as the most significant macro-economic threat today. Are inflation worries overblown or do we risk returning to a 1970's era inflation or stagflation period?

RB: Sustained rapidly rising inflation is one of the most significant macro-economic risks that investors face, today and every day. But how likely are we to enter a rapidly rising inflation environment akin to the 1970s? Not very. Despite eerie similarities to the early '70s (high military spending, expanding government social programs, questionable fashion choices) and short-term inflationary pressures, several key ingredients for inflation are notably absent. These fundamentals include US GDP remaining under its full production potential (indicating supply of products is greater than demand); the velocity of money has decreased by 20% from Q4 2019 through Q1 2021, continuing a 20-year trend of decline (a sign of decreased purchasing); slowing US population growth (accompanied by aging population demographics) suggests downward pressure on future demand; a 20-year decrease in labor's share of GDP growth (in place of capital and technology) that has hollowed out the middle class; a secular increase in globalization that has resulted in lower cost of production (currently under cyclical pressure); and the increased velocity in which technology is lowering costs in manufacturing and services.

To quote US Federal Reserve Chairman Powell, inflation appears to be "transitory" and short-term in nature. This transitory inflation is a result of low base measurement (prices declining in Q2 2020), stressed global supply chains, government support and intervention, and pent-up consumer demand. These short-term pressures may persist for 1-2 years but sustained high inflation should be limited without a more permanent shift in the aggregate demand for goods and services.

Brian, what do you see driving the inflation discussion?

BL: My view is much of the current inflation is policy-driven, both monetary and fiscal policy. The Fed has flooded the market with liquidity in response to COVID lockdowns and Congress has allocated trillions in new spending and support to taxpayers at the same time COVID-related interruptions to the supply chain has occurred. Look at lumber: prices today are back at 2018 levels under $400 per thousand board feet compared to over $1,500 in late May. When supplemental unemployment and other programs designed to transfer cash to taxpayers ends, growth in GDP is likely to return to a range of 2% to 3% real growth which will not be inflationary.

Clint, where should investors be looking to see if inflation is indeed transitory or long-term?

CP: To gauge the inflation outlook, just look at the bond market. If the expectation is prolonged inflation, then I would imagine the 10-year yield would be north of 2%. The 10-year breakeven inflation rate is roughly 2.25%, or just slightly above the Fed's long-term target. Supply chains were greatly disrupted due to COVID in 2020. A global economic shutdown followed by a reopening is going to cause wide discrepancies in inflation expectations. My estimation is that inflation will be more transitory. But if the Fed gets it wrong, we could be stuck with higher rates combined with a slowing economy.

Sam, what does history suggest investors should expect both now and in the future based on your inflation expectations?

SS: The stag-flation scenario of the 1970s was fueled in the late 1960s by war and wages; the war in Vietnam and the war against poverty (President Johnson's Great Society), combined with the union-influenced increase in wages. At the beginning of the 1970s, the Y/Y rise in headline CPI was 5.3%; by the end of the decade, it was 12.4% and averaged 7.9% for the entire decade. Not surprisingly, the S&P 500 posted a compound annual growth rate of only 1.6%, the weakest for all decades since WWII. At CFRA, we don't see a similar long-term surge in inflation. We think Headline CPI peaked in June at 5.4% and will moderate slowly, edging lower to 5.0% by year end and average 2.8% during Q3 2022.

Energy plays a large part in gauging inflation and gas prices have risen over 200% in less than a year in many locales. Past Administrations, Democrat and Republican, have taken a hard stance against OPEC and their influence in the oil market. The current Administration appears to be taking a more conciliatory approach in asking OPEC for help. Where is energy headed, will it remain a headwind to economic recovery, and is U.S. energy independence over for the time being?

SS: There is an old rule of thumb that for every $10 sustained increase in the price of oil, it strips 20 basis points from U.S. GDP growth. Granted, that impact continues to be lessened as we move to electric vehicles, solar heating, etc. Also, the U.S. became a net exporter of refined petroleum products in 2011 and is now more than 90% self-sufficient. After averaging less than $34 per barrel for WTI oil in 2020, as a result of the Covid lockdown, Action Economics (AE) forecasts WTI to average $65/bbl in 2021 and $72 in 2022. However, AE has incorporated this projected increase into their GDP forecasts, which are 6.1% for 2021 and 4.7% for 2022.

Clint, is energy an economic issue or is it a political issue in your opinion?

CP: One the one hand, Biden is calling for OPEC to drill in order to boost supply and lower prices. On the other hand, he is not calling for U.S. producers to increase production. After all the talk of energy independence over the years, the U.S. is still in bed with OPEC. Energy policy is highly political. The path forward in the long run in the U.S. is about renewable energy, which is a good thing. In the short run, however, the economy still runs largely on fossil fuel. Hence our current predicament with OPEC.

Rich, energy has been a much larger share of GDP in the past, it is still important to the economic cycle?

RB: Energy and oil prices tend to be highly volatile through the economic cycle and generally precede economic activity. Since 2003, when the price of WTI oil per barrel was ~$40, the price per barrel has ranged between $25-120. Though the price of oil has averaged about $75/b, it is expected that the cost of oil as a % of GDP will rise to about 2.8% for 2021, which is below the long-term average of 3.2%, according to Morgan Stanley. The recent rise in prices has been attributable to growth in demand rather than supply issues, which indicates sustainable economic growth. As the US has transitioned from an industrial to services driven economy over the prior decades, volatile energy prices have had less of an impact on economic production. Though the US is now exporting more oil than it imports as of 2020 on an annual basis, the US is far from independent from its trading partners and OPEC, which makes up 40% of the world's production.

Brian, the U.S. has never really had a cogent national energy policy (before the proponents of the Green New Deal), will that change?

BL: I think the surge in gas prices has more to do with domestic policy decisions than increase in demand driving prices higher. The elasticity of oil prices is extremely high as we saw during the lockdown of the global economy. Oil, once drilled, has to go somewhere and when you get a demand shock like we experienced it does not take long before no more capacity can be managed effectively. I expect a robust national debate on energy as technology has made it apparent we have ample, low cost, energy that can be produced domestically. If we constrain domestic production I would expect oil to trade in the $60 to $80 range over the next couple of years. If restraints were removed, a range of $40 to $60 is a more realistic forecast. I believe we should set policy in a way that facilitates allowing us to control our own energy destiny through domestic production and not rely on OPEC to act in our economy's best interest.

We might have set a record for the number of responses in a forum without mention of the Fed. My guess is that Chairman Powell has enjoyed being less in the spotlight over the last 6 months. The Fed recently announced a likely tapering of bond purchases before the end of 2021 and ending the quantitative easing by mid-2022. How much might these actions impact risk-taking among investors?

BL: The Fed's balance sheet has risen more than 800% since 2007 so you cannot ignore the role of QE in the meteoric rise of risk assets. The difference between today, and say 2013, is the level of confidence that investors have that the Fed will support stock prices. It is entirely possible this is mis-placed confidence, but the result is markets believe the Fed has their backs. The first place you would expect to see dislocation from a Fed taper would be in high yield bonds. There is barely a yawn in high yield with spreads barely budging higher but still very close to historical lows. Good or bad, the Fed has convinced the markets to trust in them and I expect markets will do exactly that.

Rich, tapering can be interpreted as positive because the economy no longer needs the stimulus. Will the markets acknowledge that?

RB: Tapering of bond purchases should result in a rise in treasury yields, with a likely outcome being a further steepening of the yield curve. However, yields are dependent on the supply and the market's expectations for future growth as well. In 2013, yields initially rose, but markets ultimately changed their view, anticipating slower growth and lower inflation, which led to yield curve flattening. Given the Fed has announced its timeline and plans to taper, it's assumed that markets have priced in the probability of these actions occurring on schedule. With these built-in expectations, delays in tapering may signal the economy is not on the Fed's desired pace, which then may result in a risk-off reaction or transition to risk-off behavior. Accelerated tapering could lead to a sell-off in risk assets in the short-term but ultimately would signal that the economy is healthy, which may lead to eventual risk-on behavior as seen in 2014.

Sam, we have lived through tapers in the past, what might have been forgotten about that period?

SS: Investors worry that another "taper tantrum" will emerge in 2021 as it did in 2013. But do they have that much to fear? Not if history repeats. The 2013 tantrum was triggered by comments made by then Fed Chair Ben Bernanke during a congressional hearing on May 21. Immediately following, the market retreated. Yet this selloff only resulted in a 5.8% drop for the S&P 500 lasting from May 21 through June 24. What's more, the market then turned around after realizing that if the economy was no longer in need of Fed stimulus, it would be able to expand on its own, as well as push EPS higher. The S&P 500 recovered all it lost in only 17 calendar days and then soared 15.1% in the following six months, along with 9 of 10 sectors in the S&P 1500 and 96% of its sub-industries. The market did go on to stumble twice in 2014, sliding 5.8% and 7.4% starting in January and September, respectively, but it wasn't until May of 2015 – two years after the fact – that the S&P 500 succumbed to a more meaningful 14.6% decline.

Clint, what do you believe the Fed's ultimate strategy is in making the recent announcement?

CP: We're 13 years removed from the financial crisis, the economy is growing, and the Fed is still purchasing bonds. More than likely this is a strategic move by the central bank to restore some dry powder for the next crisis that comes around. Let rates drift higher for now by easing or eliminating bond purchases. But investors in general know that the Fed will be there to provide liquidity as needed in the event of a crisis. So perhaps easing or ending the bond purchases for now might not be that impactful because the Fed ultimately has our back.

Do you believe excessive leverage currently poses a risk to the economy and markets? Will the Fed removing some accommodation cause leverage to diminish?

CP: Historically, the unwinding of leverage is a painful process for investors. The most recent example obviously is the 2007-08 financial crisis. Interestingly, the disaster at Archegos Capital earlier this year has been largely forgotten. When a family office failed to make a margin call on its leveraged positions, investment banks racked up losses of about $10 billion on a highly concentrated portfolio. If there's one Archegos there could be a dozen more. I can't imagine a scenario where the unwinding of such leverage wouldn't pose a risk to the overall markets.

Sam, leverage can be productive or non-productive. Do you see a crisis on the horizon?

SS: Leverage has always been a concern for investors. One measure -- margin debt as a percent of GDP -- is currently higher than at any prior market peak in the past 60 years. With the 10-year yield currently hovering around the 1.30% area, interest rates pose little risk to government, corporate, or individual debt, but could quickly become an albatross should rates begin a sustained increase, which we currently don't foresee.

Brian, what do you see driving the high levels of leverage?

BL: Margin debt has risen an astounding 60% year-over-year according to Yardeni data and remains very close to $850 billion. Investors are not the only ones gorging on low rates as seen by the growth in leveraged buybacks. This occurs when a company borrows money and uses the proceeds to buy back their stock in hopes of increasing their EPS. It is not at all surprising that leverage would be at such levels given the Fed's commitment to keep interest rates near zero even as the economy grows at a healthy pace and inflation exceeds the Fed's target. Leverage works similarly to short interest in a correction by forcing people to sell creating the potential of turning a correction into a crash.

Rich, how does the Fed's interventionism impact the amount of leverage we see today?

RB: Excessive leverage poses a threat for faster and more acute economic and market deterioration, as well as the threat of permanent loss of capital to investors. An accommodative Fed that keeps interest rates low will inadvertently incentivize the increased use of leverage until the marginal cost of leverage is equal to its marginal benefits (what can be financed with it). Pensions, foundations, endowments, and savers around the world have been operating under investment and spending models that demand a 5-7% cash yield that can be distributed to meet the various funding obligations of their respect institutions. A 5% yield is a readily achievable goal when interest rates are non-zero, but a much more difficult bogey in the current interest rate environment.

Enter leverage. Leverage can be helpful too in boosting returns and accretive to economic growth to the extent that the capital is funneled to economically viable projects. Conversely, leverage can also cause permanent loss of capital if used carelessly. An assumed increase in interest rates will decrease the marginal benefit of leverage and should result in a moderate reduction of leverage in the financial system. Corporate leverage will also likely decrease as the cost of servicing new debt increases; equity prices may be pressured as a result.

What sectors of the market are likely to lead as 2021 comes to an end and into 2022? Also, with valuations at elevated, if not nosebleed, levels, do you expect passive indexing, active management, or hedge funds to provide the best performance over the next 12 months?

RB: Financials has several supportive tailwinds that may help propel the sector through the end of 2021: M&A activity; high trading activity; the reversal of punitive regulatory restrictions. Bank profits have surged in the first half of 2021, but current valuations suggest there may be more room to grow.

The next 12 months are expected to be predominately growth oriented as the global economy continues to recover from the COVID-19 pandemic. The equity market is currently pricing that well. I would expect active management and hedge fund to identify the bifurcation within industry winners/losers and to outperform passive markets.

Clint, what bright spots do you see for investors?

CP: Financials and energy could continue to lead the way for the remainder of 2021, particularly if interest rates edge higher and demand for oil remains elevated. But I wouldn't count out technology. If you look at the returns across sectors or factors since the onset of COVID in 2020, the performance differentials at times have been substantial. This suggests that active management, either through individual security selection or a tactical approach, might add value over a buy-and-hold approach.

Sam, you track both momentum and fundamentals, where is the cream rising to the top?

SS: That depends on how long this stock-market advance lasts before slipping into a correction. In the later phases of a bull market, passive (index) portfolios have typically performed well, since the indexes remain 100% invested, while advisors might be encouraged to trim back risk exposure as fundamentals point to an increase in speculation. There is an old saying on Wall Street: "When the going gets tough, the tough go eating, smoking, and drinking; and if they overdo it, they have to go to the doctor." In other words, when the market experiences a sell-off, investors tend to gravitate toward those sectors with fairly static demand, such as consumer staples, health care, and utilities. Should a correction in the market occur before the end of October, it would fit in with classic seasonality. Specifically, the S&P 500 has posted its strongest six-month return from the end of October until the end of April, recording an average increase of 6.8% since WWII versus 1.7% for the more defensive six-month period. During the November through April period, the cyclical sectors – consumer discretionary, industrials, materials, and tech – typically outperformed the market since 1990, while the defensive consumer staples and health care groups held up best in the challenging "Sell in May" period.

Brian, care to opine on passive versus active management as well as where you see opportunity?

BL: In a low interest rate environment, which I expect to last almost indefinitely, growth will typically be favored over value. This should allow technology with strong EPS growth and a reasonable PEG ratio to outperform the broad market in my view. There are also some niche sectors/sub-sectors that I believe are still attractive like Healthcare Real Estate and logistics companies. Many supply chains remain impaired by COVID providing a tail wind for leading logistic companies. Looking forward, I believe index outperformance is very late stage and both active management and hedge funds are likely to outperform over the next 12-24 months. If the market correction is less than 20% I would expect active management to outperform, if over 20% then hedge funds likely come out on top.

For the 3 years leading up to the COVID-19 market correction the Low Volatility factor performed exceptionally well, almost equaling the total return of the S&P 500. The recovery off the March 2020 lows has been a different story with low vol dramatically trailing the broad market returns. Is this likely a short-term phenomenon or do you expect low vol to continue to lag?

SS: CFRA offers buy/hold/sell recommendations on nearly 2,000 ETFs, based not on a trailing 36-month relative performance but rather on forward-looking analysis. CFRA's ETF Ranking System evaluates ETFs on cost, the risk inherent in the underlying holdings, and, most important, the price-appreciation potential for the stocks within these ETFs, using each company's 6-12 month investment potential as defined by the stock's STARS (CFRA's STock Appreciation Ranking System). Currently, the S&P 500 Low Volatility ETF (SPLV $64) carries a 1-STAR (Strong Sell) aggregate ranking, as compared with the 5-STARS (Strong Buy) ranking currently held by the S&P 500 High Beta ETF (SPHB $71).

Rich, how much does the index composition impact recent and historical performance?

RB: The Low Volatility Factor has been found outperform the broad market over long periods of time but has often failed to capture 100%+ of the market upside during mark rallies. Applying that thesis to the COVID recovery specifically is informative: the composition of the Low Volatility Factor Index is overweight utilities by approximately 20% and underweight Information Technology by approximately 15%. With Information Technology being a market leader and Utilities being a market laggard, the considerable difference in positioning has caused the Low Volatility Factor Index to lag.

Brian, it has been said there are no free lunches; do investors have unreasonable expectations with Low Vol?

BL: Investors are aware that when allocating to Low Volatility stocks they expect a higher degree of protection on the downside and are willing to sacrifice some upside to gain that. Unfortunately, during the COVID correction Low Vol did a poor job overall of sheltering risk dropping almost the same amount as the broad market and, as expected, have definitely lagged on the recovery. Low Vol tends to overweight utilities, financials and healthcare (hospitals and pharma as opposed to biotech) and these "value" sectors have definitely lagged the market. I expect Low Vol to continue to trail the broad market at least until a substantive correction in equities occurs that takes the wind out of the sails of growth stocks.

Clint, what are some reasons why investors might want to stick with Low Vol?

CP: What happened in March of 2020 was a perfect example of how all factors can look the same when correlations go to one. Indiscriminate selling due to an external shock to the global economy can look much different than a longer-term rotation across factors based on the business cycle. Low volatility stocks became just as risky as everything else but failed to recover on the rebound due to the sector exposures. But I wouldn't dismiss the low volatility factor entirely. Simply look at 2018, when the S&P 500 had a -14% drawdown in the fourth quarter while the low volatility factor was down roughly -5%.

There is strong consensus that Fed accommodation is responsible for the tide that has lifted all boats. Is it possible in today's market environment for investors to find non-correlated assets to invest in?

CP: Finding low to negatively correlated return patterns is becoming increasingly difficult. Typically, bonds have exhibited low to negative return correlations to stocks, and, to a large degree, still do. But the return expectations for bonds is not what it used to be. Valuations for all assets are ultimately tied to interest rates. If we get a shock in rates or runaway inflation, most asset classes will initially reprice to the downside in which case a tactical use of cash or short positions might be the only source of non-correlated returns.

Sam, each period is different but where have investors found non-correlations in the past?

SS: During market declines over the last 50 years, defensive sectors rarely rose in price, they just fell less than the overall market and their cyclical sector peers. However, Treasury bonds have been among the few easily accessible asset classes (by retail investors) that have offered a negative correlation with equities. Gold, as well as commodities in general, such as found in the S&P GSCI Index, have also offered shelter from the storm.

Brian, what role does portfolio construction play in ensuring diversification through non-correlation?

BL: It really depends on how you go about identifying negative correlation. Correlations are extremely dynamic, more so today than in the past. Long duration Treasuries provide strong negative correlation about 70% of the time given recent market trends making it a good place to look when equity volatility rises. While much more difficult to curate and underwrite, private credit is another asset class that can provide shelter during equity market drawdowns. Being tactical in your allocations during a market correction can aid in mitigating risk.

Rich, given the Fed's influence on how all asset classes might respond in a correction, is there value in looking at more esoteric assets?

RB: Yes, differentiated investments are still lurking in the far corners of the market. But if you want to find non-correlated, differentiated investments than you have to look in differentiated places. Those investments are typically under-research, under-trafficked, "off the run" investments. Further, new assets are created and perfected constantly – 10 years ago the concept of investing in royalties was considered niche – now there are music royalties, health care royalties, patent royalties, etc. that are accessible in the public markets.

What is an investment theme that is largely ignored today that investors should be taking note of? Along the same vein, what areas might provide shelter or a hedge if the markets were to sharply correct?

RB: Broadly speaking, utilities offer a reasonable haven for investors that are concerned about a sharp market correction. Many utilities operate on contractual agreements and thereby offer relatively consistent cash flows to investors. More specifically, water infrastructure may provide a compelling defensive investment thesis. Water infrastructure is most often managed on the local municipal level and new capital expenditure (vs. operating/maintenance cost) has been severely underfunded for decades. The existing water infrastructure was built between the 1950s-1970s and is completely inadequate for today's populations and tomorrow's climate change challenges. New capital and private investment will be required to improve or replace existing infrastructure. Given the demand inelasticity for water, ownership of water infrastructure may offer modest appreciation potential and substantial downside protection.

Clint, you know a bit about hedging, can Treasuries offer investors the protection they will be seeking?

CP: We only need to look back to February and March of 2020 to get a sense of what hedged well, and ultimately it was cash. Before the Fed stepped in, liquidity in the bond market temporarily dried up and spreads widened substantially. Equities were in a downward spiral. Cash was about the only source of stability at the time. An investment theme, or rule of thumb, is to not chase yield. With low interest rates, investors might ignore or fail to appreciate the risks involved when stretching for higher yield.

Sam, you maintain a very global perspective in the CFRA portfolios, how important is it to avoid becoming myopic on the U.S.?

SS: After outperforming the S&P 500 in 7 of 8 years through 2009, the MSCI-EAFE Index underperformed the 500 more than 80% of the time since then. Today, the rolling 5-year relative return for the MSCI-EAFE is one standard deviation below the mean since 1970. In addition, the relative P/E, based on forward 12-month EPS estimates compiled by S&P Capital IQ consensus forecasts, is more than two standard deviations below the 15-year mean. Finally, the developed international benchmark is yielding nearly twice the S&P 500's.

Brian, we end it with you, where might readers look today for opportunities they had not previously considered?

BL: I think Closed-End Funds (CEFs) do not get near the love they deserve from investors. Many investors are not even aware of the structure of CEFs and how they differ from ETFs or open-end mutual funds. CEFs have the ability to trade at a discount or premium to NAV. This means if you are selective, you can own companies or bonds for less than they are trading in the public markets. Investors looking for income from their portfolio should look at Muni CEFs, but you can also find bargains in real estate, preferreds, and even AI and technology although they often trade at a premium.

My genuine gratitude to Sam, Rich and Clint for taking the time to provide thoughtful, sometimes provocative responses to these questions. I believe our readers will enjoy and benefit from the wisdom and experience of the panel.

Roundtable Contributor Bios

Brian Lockhart

Brian Lockhart is an owner and a member of the Management Board of Shepherd Kaplan Krochuk. He is the founder, Chief Executive Officer, and Chief Investment Officer of Peak Capital Management, LLC (PCM), which SKK acquired in February 2020. With over 25 years of portfolio management experience, he serves as the co-portfolio manager of PCM's suite of proprietary strategies, directing the company's dynamic allocation of distinguished ETF investment strategies implemented on behalf of high net worth and institutional clients. Brian has been featured in multiple media outlets, including Barron's, Forbes, Fortune and Business Week. He is an active conference speaker, presenting on topics such as portfolio and risk management and alternative investments. Brian is on the boards of Newdea and NanoDX, Inc. Brian received a Bachelor of Science in Business Administration from California Polytechnic State University in San Luis Obispo, California. Brian was also awarded a certificate for completion of the Investment Decisions and Behavioral Finance Program (11/2017), at John F. Kennedy School of Government at Harvard University, Executive Education.

Richard Blair

Richard Blair is Senior Vice President of Research for SKK, with primary responsibility for developing investment strategy and alternative investment research. He conducts research on capital markets, securities analysis, macroeconomics, investment strategies and portfolio construction for institutional, endowment & foundation, and high-net-worth clients. Rich leads qualitative and quantitative due diligence of alternative investment managers and strategies. Rich is a member of the Firm's Research Committee and assists the Firm's Investment Committee. Prior to joining SKK, Rich contributed to asset allocation, portfolio construction, and manager selection for the Amherst College Investment Office. He is a graduate of the University of Delaware, and is a CFA charterholder.

Sam Stovall, CFP®

As Chief Investment Strategist, Sam Stovall serves as analyst, publisher and communicator of CFRA's outlooks for the economy, market, and sectors. He is the Chairman of the CFRA Investment Policy Committee, where he focuses on market history and valuations, as well as industry momentum strategies. Sam is the author of The Seven Rules of Wall Street, and writes weekly "Sector Watch" and "Investment Policy Committee meeting notes" on CFRA's MarketScope Advisor platform. His work is also found in CFRA's flagship weekly newsletter The Outlook.

Prior to joining CFRA, Sam was Managing Director and Chief Investment Strategist at S&P Global for more than 27 years, and served as Editor In Chief at Argus Research, an independent investment research firm in New York City. He received an M.B.A. in Finance from New York University and a B.A. in History/Education from Muhlenberg College, in Allentown, Pa. Sam is also a Certified Financial Planner.

Sam's volunteer efforts center on financial literacy. He is a board member of W!SE (Working in Support of Education), an educational not-for-profit that aims to improve the lives of young people through programs that develop financial literacy and readiness for college and careers. He is also a Trustee of Muhlenberg College.

Clint Pekrul, CFA

Clint Pekrul, CFA is Head of Research at Peak Capital Management (PCM), and is responsible for the development and implementation of the firm's quantitatively driven strategies. Clint has over 16 years of industry experience. Prior to joining PCM, Clint worked in the asset management group at Curian Capital, a registered investment advisor, where he managed $2BB in managed risk strategies. Clint is often heralded as a pioneer in creating and managing portfolios using ETF's. Clint holds a B.S. in business administration from the University of Oklahoma, and is a Chartered Financial Analyst. Clint resides in Denver where he enjoys fly fishing when he is not managing portfolios.

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